Bulletin

2003-11B

IMPACT OF PREMIUMS ON NOTES OR BONDS ON
LEVY LIMITS UNDER PROPOSITION 2 ½

TO:	Mayors and Selectmen	City and Town Managers
	Boards of Assessors	Executive Secretaries and Finance Directors
	Auditors and Accountants	City Solicitors and Town Counsel
	Collectors and Treasurers	Regional School Superintendents, Treasurers

FROM: James R. Johnson, Director of Accounts

DATE: May 28, 2003

SUBJECT: Impact of Debt Exclusions on Levy Limit Calculation

This *Bulletin* discusses calculation of levy limits under Proposition 2 ½ arising from debt exclusions approved at referendum. The current level of interest rates has produced effects in the municipal securities market which must be addressed to preserve the intent of debt exclusions under Proposition 2 ½.

Effective with the FY04 tax rate approval process, additions to the levy limit for a debt exclusion are restricted to the true interest cost incurred to finance the excluded project. Premiums received at the time of sale must be offset against the stated interest cost in computing the debt exclusion.

A. Background

For many years, our annual instructions and forms for the tax rate approval process have covered this subject; Form DE-1 is used to document the amount added to the levy limit. The clearest case exists when bonds have been issued, and the amounts of principal and interest due in the fiscal year are fixed. When the referendum has only recently been approved, or when temporary notes are contemplated, the amount of interest is estimated based on the timetable for borrowing and the likely rate of interest. Our instructions and forms make provision for adjustment of such estimates to actual costs in the subsequent year's tax rate approval.

In the United States, interest rates have fallen to levels not experienced for decades. As a result, the market for sale of notes and bonds by municipal issuers in recent months has frequently produced bids at a stated coupon rate, with a premium payable upon sale of the securities which creates a true interest rate substantially less than the coupon rate. In the Massachusetts marketplace, a premium has historically been a nominal amount, if bid at all; the purpose was often to provide the issuer a means to break ties among competing bids. G. L. Ch. 44 §20 provides that such premiums, less costs of issuance of the securities, are general revenue of the issuer.

B. Proposition 2 ½ Debt Exclusions

The referendum question asks the voters: "Shall the (city/town) of be allowed to exempt from the provisions of proposition two-and one-half, so-called, the amounts required to pay for the bond issued in order to (state the purpose or purposes for which the monies from the local issue will be used)?" Conventional logic is that the specified purpose and the limited duration represented by such an authorization are key factors in the record of approval of debt exclusion questions. Most such exclusions are for construction of schools, police or fire stations, libraries or similar facilities.

C. Amount of Premiums

Financial publications are reporting premiums on recent sales, principally of bond anticipation notes, in the hundreds of thousand of dollars, and in one case, well in excess of a million dollars. Such amounts have clearly become material. A recent example (amounts rounded for simplicity) is:

> Bond anticipation notes of $48,419,000 issued 5/14/03 due 5/14/04, sold at 2%, included a premium of $425,700, for a true interest cost (TIC) of about 1.12%. Of the note issue, $41,286,000 (or about 85%) represented two authorizations which have been excluded from the Proposition 2 ½ limits.

D. Impact on levy limit calculation

At present, the amount added to the levy on an excluded authorization would be the interest due at maturity – computed at the coupon rate. In the example, this would be $823,000 (principal of $48,419,000 times 2% or $968,000, times 85% for the excluded portion); if the town levied to the levy limit, this entire amount would be added to the levy. <u>However, the true interest cost to the town for these two authorizations is only $462,400</u> (excluded principal times 1.12%). <u>We conclude that only this amount should be added to the levy limit.</u> The portion of the premium attributable to the excluded authorizations ($823,000 interest at coupon rate, less $462,400 interest at TIC, equals $360,600), should reduce the amount added to the levy limit in the same manner as reimbursement from the school building assistance (SBAB) program or grants from the board of library commissioners.

We feel that the recent substantial premiums reflects conditions in the financial marketplace which do not reflect financing of the building projects which the voters approved. The premiums are revenues of the city or town logically available to reduce the interest payment, often in a subsequent fiscal year. Accordingly, we feel that such credits to the city or town budget are not within the scope of the debt exclusion.

The instructions and forms for the FY04 tax rate process to be issued in July will reflect this change. The Bureau of Accounts field representative will work with city or town assessors, accountants and auditors, and treasurers to insure proper completion of Form DE-1.

D. Accounting procedures

As noted above, existing law provides that the premiums are general revenue. This treatment is consistent with that afforded SBAB reimbursement, which is likewise adjusted in computing the amount of the debt exclusion.

If receipt of the premium and the payment of interest at maturity occur in different fiscal years, reservation of the premium for future year's debt service, rather than closing to unreserved fund balance, is required at the end of the fiscal year when the premium was received.

The Bureau of Accounts field representative assigned to your city or town can provide assistance in this important matter.